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Nos. 87-453 and 87-464

IN THE

# Supreme Court of the United States

OCTOBER TERM, 1988

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AMERADA HESS CORPORATION *et al.*,
*Appellants,*

v.

DIRECTOR, DIVISION OF TAXATION,
*Appellee.*

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TEXACO INC. and TENNECO OIL COMPANY,
*Appellants,*

v.

DIRECTOR, DIVISION OF TAXATION,
NEW JERSEY DEPARTMENT OF THE TREASURY,
*Appellee.*

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**On Appeals from the Supreme Court of New Jersey**

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## REPLY BRIEF FOR APPELLANTS

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## REPLY BRIEF FOR APPELLANTS

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New Jersey asserts a sweeping power to tax multi-state businesses far beyond what this Court's decisions have sanctioned. Under its theory, a state may freely single out for disadvantageous income tax treatment costs associated with any form of economic activity that is conducted exclusively outside its borders.

New Jersey and its state amici brush aside the territoriality and anti-discrimination principles that ordinarily constrain state taxing power. Territorial limitations, they say, have no bearing on income tax deductions; so long as the state adds nothing to the taxpayer's unitary gross receipts, the manner in which it allows or

disallows deductions in defining net income is constitutionally irrelevant, no matter how geographically tailored the deductions may be. NJ Br. 23-25; Iowa Br. 15-17.[1] Likewise, in their view, constitutional protections against discriminatory state taxation do not apply in this case: a state is free to impose unique tax burdens on any exclusively out-of-state activity, so long as there is no identical in-state activity that can be said to benefit from the discrimination. NJ Br. 37-41; Iowa Br. 19-27.

New Jersey's position is at war with much of this Court's Due Process and Commerce Clause jurisprudence. If, as New Jersey argues, a state may lawfully fashion its allowable tax deductions to disfavor the exclusively out-of-state activities of a multistate taxpayer, even the most rigorous enforcement of this Court's limitations on the proper scope of a unitary business, coupled with the strictest insistence upon a geographically benign apportionment formula, will be ineffective to deter the state from taxing more than its fair share of multistate net income. And if a jurisdiction may lawfully affix discriminatory tax burdens to any out-of-state activity that has no identical in-state counterpart, the free trade purpose of the Commerce Clause may easily be frustrated by the successive imposition of retaliatory tax measures that penalize taxpayers on account of their exclusively out-of-state operations.

Perhaps aware of the extravagance of its assertions, the state strains to fit this case within the Court's precedents, insisting at the outset that the issue here was decided in *Exxon Corp. v. Wisconsin Department of Revenue*, 447 U.S. 207 (1980). NJ Br. 10, 14-16. That venture founders, however, on a misreading of this Court's decision and a misconception of the federal Windfall Profit Tax Act. In the end, New Jersey must stand or fall on its novel and expansionist view of state taxing power.

[1] "Iowa Br." refers to the amici curiae brief filed by Iowa and 11 other states.



### A. This Case Is Not *Exxon v. Wisconsin*

The question in *Exxon v. Wisconsin* was whether the state could include in Exxon's preapportionment tax base that portion of its total net income that the company's internal accounting system attributed to integrated production and refining activities conducted outside the state. The Court held that the out-of-state production and refining operations and the in-state marketing operations were part of a single unitary enterprise and that Wisconsin accordingly could tax a fairly apportioned share of the net income ultimately earned from all those operations. 447 U.S. at 224-27.

New Jersey imagines that this case presents the same issue. In its eyes, appellants want to "exempt from the New Jersey CBT a portion of their unitary net income" by using "a form of separate accounting" to exclude "a definable, separable wellhead profit." Br. 9, 18. But no party here seeks to exempt any portion of its unitary income from the New Jersey tax base, and no company argues that crude oil production or "wellhead profit" is outside the scope of its unitary business. The issue, instead, is whether the state, having incorporated in its preapportionment tax base appellants' income from all sources, including their exclusively out-of-state production activities, may selectively disallow an offsetting deduction for a discrete class of costs necessarily incurred solely on account of those out-of-state production activities.

*Exxon v. Wisconsin* is of no help at all to the state on that issue. While it supports the inclusion of income derived from integrated crude oil production, it provides no authority for ignoring the associated costs of crude oil production. On the contrary, the Court's analysis assumed that the unitary stream of income embraced not only company-wide revenues, as New Jersey would have it, but also company-wide costs and expenses. *See* 447 U.S. at 221. The Court has long taken for granted that the apportionment of unitary net income requires "[a]

division of revenues *and* costs" in a manner designed to "produce . . . a uniformity of net return, or a fair approach thereto." *Norfolk & Western Ry. v. North Carolina ex rel. Maxwell*, 297 U.S. 682, 684 (1936) (emphasis added).

When a state uses the unitary business method, therefore, it must take the bad with the good. It cannot include in the tax base a company's total income from all sources but then cherry-pick the costs, allowing a deduction for those incurred inside the state while disallowing a deduction for those incurred outside the state. Such disparate treatment of out-of-state costs necessarily negates the geographical "uniformity of net return" (*id.*) and thereby subverts the premise of formula apportionment.

Appellants fully accept the unitary business method in this case. We ask only that the method be applied consistently to both sides of the ledger and that out-of-state costs be treated no less favorably than in-state costs. Nothing in *Exxon v. Wisconsin* sanctions New Jersey's departure from that even-handed treatment.

### B. The Windfall Profit Tax Is a Site-Specific, Out-of-State Cost

We argued in our opening brief that New Jersey's inclusion in its tax base of income derived in part from exclusively out-of-state oil production activities, together with its disallowance of an offset for WPT costs incurred solely in connection with those activities, necessarily yielded a geographically asymmetrical tax base and an impermissibly exaggerated state tax liability. The foundation of our argument was that WPT liability is incurred on account of the removal of each barrel of crude oil from the vicinity of the producing well—an activity that is both site-specific and geographically localized.

Until now, no one had disputed that premise. The New Jersey Supreme Court had acknowledged that the WPT



is "imposed on production at the wellhead rather than on . . . producers' overall net profits or income" and that "the basic measure of the windfall profit [is] the difference between the uncontrolled and controlled price of a barrel of crude oil at the point the oil [is] removed from the producing property." J.S. App. 5a-6a. New Jersey itself had conceded at the jurisdictional stage in this Court that WPT costs "have a geographic source outside the State." Motion to Dismiss or Affirm 14. And the Solicitor General, in response to this Court's invitation, had concluded that "the windfall profit tax is site-specific in the critical respect—liability for it is as directly related to activity that takes place at a geographically identifiable place as is liability for an ordinary severance tax." U.S. Br. 24.

In its merits brief, however, New Jersey argues for the first time that "the WPT is *not* a site-specific cost." Br. 24 (emphasis added). It asserts that the WPT tax base is the product of activities conducted throughout the United States and is computed based on factors unrelated to the time and place of removal. In the state's view, therefore, WPT costs are tied to no geographically isolated events, and New Jersey's disallowance of a deduction for those costs does not affect the geographical symmetry of the tax base.[2]

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[2] New Jersey's shift of position is part of a wholesale repudiation of both its own arguments below and the analysis underlying the state Supreme Court's statutory holding. New Jersey conceded in the state courts that the WPT is "imposed when crude oil is removed from a producing property." NJ App. Br. 17. The state's theory was that the WPT is nevertheless a tax on "income or profits" within the scope of the add-back provision, because "realization [of income] occurs upon the lifting of oil from the ground," even if no sale occurs at that point. *Id.* at 75. *See* J.S. App. 25a (describing the state's position). The New Jersey Supreme Court likewise concluded that the WPT, though "imposed on production at the wellhead," qualifies as a tax on income or profits because "oil production income is realized [at the wellhead] when the oil is lifted." J.S. App. 5a, 29a. The site-specific nature of the WPT was of no constitutional concern to New Jersey in the state courts. It argued, and the state Supreme Court held, that income tax deductions are

The state's new theory rests on a mistaken understanding of the federal statute.

### 1. *"Windfall Profit" Is Not a Component of Net Income*

The state's principal contention is that "windfall profit," as defined by Congress, is part of what the state calls the "decontrol element" of net income—by which it means the portion of net income attributable to the termination of federal crude oil price controls. Br. 10, 15-16, 39 n.26. The state believes, therefore, that "windfall profit" is "no different in character" from bottom-line corporate net income. Br. 11. Because the measure of the WPT is a component of unitary net income, under New Jersey's thesis, and because unitary net income is derived from corporate activities everywhere, including "the companies' activities in New Jersey" (Br. 12), the state concludes that the WPT is no more site-specific than any other tax on net income and cannot be attributed solely to crude oil production activities.

New Jersey's analysis is grounded on a colloquial understanding of the term "windfall profit" that bears no

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beyond constitutional scrutiny regardless of where the costs at issue are incurred. J.S. App. 33a-34a.

In a remarkable eleventh-hour turnabout, New Jersey now asserts —directly contrary to its own arguments below and the state Supreme Court's holding, but without a word of explanation—that "the companies realize *no* income until their crude oil has been sold" and that "the WPT is *not* site specific" but is affected by the producer's income-generating activities everywhere. Br. 22, 26 (emphasis added). New Jersey cannot have it both ways. If, as the state successfully argued below, the WPT is a wellhead tax on "income" "realized" upon lifting, the tax is indeed a site-specific cost of exclusively out-of-state crude oil production, and disallowance of a deduction geographically skews the tax base. If, as the state now argues in this Court, income is realized not upon lifting but only upon sale, the WPT, because it is imposed at the wellhead, is taxing something other than "income or profits" within the meaning of the add-back provision as construed by the New Jersey Supreme Court.



resemblance to the statutory definition. Under I.R.C. § 4988(a), "the term 'windfall profit' means the excess of the removal price of the barrel of crude oil over the sum of—(1) the adjusted base price of such barrel, and (2) the amount of the severance tax adjustment with respect to such barrel . . . ." The definition has nothing to do with the producer's net income or with any "decontrol element" of net income. As the New Jersey Supreme Court recognized (J.S. App. 5a-6a), "windfall profit" is keyed entirely to the incremental value of each barrel of crude oil at the point of removal and is not affected by a producer's "overall net profits or income."

New Jersey confuses the Windfall Profit Tax enacted by Congress with a classic wartime "excess profits tax." The excess profits taxes typically imposed an additional high rate of tax on a portion of corporate net income in excess of a base amount.[3] If Congress had followed that model in enacting the WPT, this would be a different case.

But Congress considered and expressly rejected that model, concluding that "an excise tax is a far simpler approach to taxing windfall profits than an excess profits tax, such as was used during World War II and the Korean War." H.R. Rep. No. 304, 96th Cong., 1st Sess. 7 (1979). It accordingly chose to "impos[e] the windfall profit tax on only one event"—removal of a barrel of crude oil from the producing premises—rather than

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[3] *See* Revenue Act of 1917, Pub. L. No. 64-377, § 201, 39 Stat. 1000, 1000-01 (imposing an excess profits tax on the amount of corporate "net income" that exceeded the sum of $5,000 plus a percentage of actual capital invested); War Revenue Act of 1917, Pub. L. No. 65-50, §§ 200-214, 40 Stat. 300, 302-08 (imposing a similar "war excess profits tax"); Revenue Act of 1934, Pub. L. No. 73-216, § 702, 48 Stat. 680, 770-71 (imposing an excess profits tax on the portion of corporate "net income" that exceeded a percentage of the declared value of capital stock); Excess Profits Tax Act of 1940, Pub. L. No. 76-801, § 201, 54 Stat. 974, 975-98 (imposing an additional tax on the amount of "net income" that exceeded a percentage of base period net income adjusted by a percentage of net capital additions or reductions); Excess Profits Tax Act of 1950, Pub. L. No. 81-909, § 101, 64 Stat. 1137-1216 (similar to 1940 Act).

on aggregate net income derived from all "stages of production and distribution." *Id.* at 43; *accord* S. Rep. No. 394, 96th Cong., 1st Sess. 66 (1979).[4]

Despite its title, therefore, the tax that Congress enacted "is not a tax on profits." Robison, *The Misnamed Tax: The Crude Oil Windfall Profits Tax of 1980*, 84 Dick. L. Rev. 589 (1980). It is a tax on wellhead value. Like a typical severance tax, the WPT is imposed and measured as of the time and place of removal. In the New Jersey Supreme Court's words, "the value of the oil" (and consequently the statutory windfall profit) is fixed "at the point of lifting," regardless of "[l]ater events." J.S. App. 29a. "The fact that the posted price may fall subsequent to the lifting of the oil or that some barrels may be lost following severance from the lease is irrelevant." *Id.* at 28a-29a. Contrary to the state's new position in this Court, the producer's WPT liability, like its severance tax liability, neither depends on nor fluctuates with the amount of its unitary net income or any "decontrol element" of net income.

The state amici, tracking New Jersey's misguided argument, assert that "the WPT is associated with the profitability of the entire unitary business" and that "windfall profit is earned, in part, as a result of Appellants' New Jersey marketing activities." Iowa Br. 7, 17. Unlike New Jersey, the amici ultimately acknowledge, albeit grudgingly, that "the windfall profit is superficially deemed by Congress to occur upon 'removal' at the production site." *Id.* at 14. They nonetheless invite the

[4] The Senate specifically considered a proposed floor amendment modeled on the wartime excess profits taxes. The amendment—described by its author as "a genuine windfall profit tax" (125 Cong. Rec. 35,230 (1979) (statement of Sen. McClure))—would have imposed on each "petroleum industry corporation" a surcharge tax of 90 percent on that portion of its net income that yielded a rate of return on capital investment in excess of the average rate of return for all manufacturing corporations. *Id.* at 35,229-30. After extensive debate, the amendment was rejected. *Id.* at 35,240-41.



Court to disregard the "structural form of the WPT"—in other words, the statutory text—and to focus instead on what amici consider the "economic reality . . . that the WPT was imposed upon the anticipated decontrolled revenues, in part due to Appellants' sales activities in New Jersey and elsewhere." *Id.*

Although Congress anticipated that producers would receive additional revenues and earn additional profits as a result of decontrol, it decided to impose a tax at the point of removal and to make downstream revenues and earnings irrelevant to WPT liability. Contrary to the state amici's approach, what matters here is the tax that Congress actually enacted, not general legislative aspirations or shorthand characterizations unembodied in the text of the statute.

### 2. *The Computation of the WPT Does Not Affect its Site-Specific Incidence or Measure*

New Jersey argues alternatively that the WPT cannot be site-specific "because its computation depends on many factors having nothing to do with the property where the oil is produced." Br. 12. But none of the "factors" to which the state points—"the removal price, inflation adjustment, and net income limitation" (Br. 26)—affects the fundamental character of the WPT, recognized even by the New Jersey Supreme Court, as a tax measured by the incremental value of each barrel of crude oil "at the point the oil was removed from the producing property." J.S. App. 6a.

a. *Removal price.* New Jersey's main point is that, in those rare instances when there is no representative field or market price for crude oil—Alaska North Slope crude oil is the only example it cites—a producer may have to compute its removal price by starting with a downstream value and then subtracting out the transportation and other post-removal costs incurred to reach that downstream point. Br. 26-29. Those costs are subtracted, however, not because they are *part* of the WPT base, but for precisely the opposite reason—they are *extraneous* to the WPT base and must be eliminated to deter-

mine the value of the crude oil as of the time and place of its removal.

Except in the case of third-party sales at the wellhead, the removal price of a barrel of crude oil is determined by reference to "the constructive sales price for purposes of determining gross income from the property under section 613." I.R.C. § 4988(c). It has long been the rule under section 613 and its predecessors that "gross income from the property" must be determined at the wellhead—"before conversion or transportation" (Treas. Reg. § 1.613-3(a))—and that value added to the mineral after removal from the vicinity of the well, including the cost of transporting the mineral to market, may not be considered in determining the proper wellhead value. *E.g.*, *United States v. Cannelton Sewer Pipe Co.*, 364 U.S. 76, 81-89 (1960); *Hugoton Production Co. v. United States*, 349 F.2d 418 (Ct. Cl. 1965) (Justice Reed, sitting by designation); *Consumers Natural Gas Co. v. Commissioner*, 78 F.2d 161, 162-63 (2d Cir.) (L. Hand, J.), *cert. denied*, 296 U.S. 634 (1935); Rev. Rul. 75-6, 1975-1 C.B. 178.

New Jersey therefore has it exactly backwards when it says that for purposes of the WPT crude oil is "valued based on factors far distant from the wellhead." Br. 29. It is to ensure that crude oil will *not* be valued based on such factors that producers must disregard them in calculating the removal price.

It may be true, as New Jersey states, that the value of crude oil at the time and place of removal is affected by "the price that refiners . . . are willing to pay for the oil" in distant markets. Br. 29. But that hardly proves that a tax measured by wellhead value is not a site-specific cost. The value of goods at a particular location may be influenced or even determined by a distant sale, without losing its character as a purely local measure of value. In *American Manufacturing Co. v. City of St. Louis*, 250 U.S. 459 (1919), for example, the Court upheld a license tax measured by the value of goods



manufactured locally, even though the local value was defined by the proceeds from subsequent sales of the goods in out-of-state markets.

Under New Jersey's contrary theory, even a state severance tax, measured by the wellhead value of crude oil at the time and place of severance, would not be a site-specific cost, because the measure of the tax, just as in the case of the WPT, would be affected by the price paid for crude oil in markets far from the wellhead. But if anything is clear, it is that a tax measured by wellhead value can be imposed only by the state within which the well is located, because that state and no other can have the necessary taxing relationship with that geographically site-specific value. *Commonwealth Edison Co. v. Montana*, 453 U.S. 609, 617 (1981); *see Merrion v. Jicarilla Apache Tribe*, 455 U.S. 130, 156-57, 158-59 n.26 (1982).

b. *Inflation adjustment.* Congress sought to tax only the increased value of a barrel of crude oil attributable to price decontrol. "Since regulated prices were adjusted for inflation, if the base prices for [windfall profit] tax purposes were left unadjusted, the tax base would accrue an element clearly unrelated to decontrol." Drapkin & Verleger, *The Windfall Profit Tax: Origins, Development, Implications*, 22 B.C.L. Rev. 631, 661 n.133 (1981). The statute accordingly provided for quarterly adjustments to the "base price" of crude oil to take account of inflation. I.R.C. § 4989(a), (b).

New Jersey believes that, because "[p]rice inflation in the general economy is plainly not tied to a single oil producing property" (Br. 30), neither the adjusted base price nor the WPT itself can be considered site-specific. But the state again misses the point: the inflation adjustment was designed to *remove* "inflation in the general economy" from the tax base so that it would not affect the producer's WPT liability.

The inflation adjustment has no bearing on the WPT's operating incidence (the removal of a barrel of crude oil) or its measure (the incremental value of that barrel at

the point of removal), both of which are inseparable from the specific producing premises. If a production state imposed a severance tax measured by the wellhead value of each barrel of crude oil in excess of a $1 base, subject to a quarterly inflation adjustment, the tax would be no less tied to the site-specific activity of severance than if there were no base or no inflation adjustment. The conclusion is the same in the case of the WPT.

c. *Net income limitation.* The state argues that the NIL, which places an upper limit on WPT liability for barrels removed from high-cost properties, "is not a site-specific computation." Br. 30. But the starting point for computing the NIL, like that for computing the removal price, is the actual or constructive sales price of the crude oil in the immediate vicinity of the producing well. *See* I.R.C. § 4988(b)(3)(A); Treas. Reg. §§ 1.613-3(a), 1.613-5(a). It is immaterial, for the reasons discussed above, that the value of crude oil at the wellhead may be affected by such "off-site factors" as "the value of the oil in the market where it is refined and transportation costs." NJ Br. 30.

Nor does it make any difference that, in computing the NIL, the taxpayer deducts from the gross value of crude oil at the producing property certain expenses, including overhead, attributable to the particular property. First, the calculation is made separately for each barrel from each property, and losses on one property do not offset gains on another. Treas. Reg. § 51.4988-2(b)(1); *see Shell Oil Co. v. Commissioner*, 89 T.C. 371, 397-98 (1987). "Net income" for purposes of the NIL is thus itself a site-specific concept that relates solely to oil producing properties outside New Jersey. It is neither part of nor derived from a producer's unitary net income. On the contrary, notwithstanding the operation of the NIL, a producer may have substantial WPT liability in a particular year even though it has no net income for federal income tax or financial reporting purposes.[5]

[5] In tax year 1981, for example, Cities Service Company had no federal taxable income but more than $316 million of windfall profit tax liability. App. Div. Jt. Appendix for Plaintiffs-Appellants 642a, 657a; App. Div. Confidential Appendix for Defendant-Appellee 61a; *see* Appendix A to our opening brief, at 1a.



Second, the NIL operates only as a circuit-breaker to ensure that the WPT does not induce a producer to shut in high-cost wells. *See Shell Oil Co.*, 89 T.C. at 385; S. Rep. No. 394, *supra*, at 29. Congress viewed the NIL as "an alternative to establishing a special category under the tax for marginal properties." Staff of Jt. Comm. on Taxation, 96th Cong., 1st Sess., *The Design of a Windfall Profit Tax* 29 (Jt. Comm. Print 1979). It is thus inaccurate to imply that the NIL defines the base of the WPT. The NIL caps the effective rate of the WPT by limiting the base for some barrels produced from certain properties. But the limit applies to a base composed of site-specific values, and its application does nothing to alter the essential quality of the WPT as a tax on the removal of crude oil from specific locations outside New Jersey.

### C. Geographical Tailoring of Deductions Impermissibly Distorts the Tax Base

In response to the examples in our opening brief (pp. 24-25, 28), New Jersey concedes that it could not lawfully inflate the numerator of an integrated oil company's payroll fraction, that it could not exclude oil production property from consideration in the company's property fraction, and that it could not magnify the income derived from exclusively out-of-state oil production activity in computing the company's preapportionment tax base. NJ Br. 25. "Any of these adjustments," the state admits, "would artificially augment [the company's] business income by factors bearing no relation to economic reality." *Id.* The state nonetheless argues that it may selectively disallow a deduction for exclusively out-of-state oil production costs, because the resulting base, though geographically unbalanced, is "economically real." *Id.*

If we correctly understand the argument, New Jersey still believes, as it contended at the jurisdictional stage (Motion to Dismiss or Affirm 15), that the territorial

limitations on its taxing power require only that it use a fair apportionment formula and that it include in the preapportionment tax base no more than 100 percent of the taxpayer's "economically real" unitary gross receipts. In the state's view, any adjustments that it makes to the base below that maximum are beyond constitutional challenge. As New Jersey reminds us, "there is no single definition of taxable income." NJ Br. 17. The amici put the argument more bluntly: "Deductions are a matter of grace . . . which the legislature can disallow as it chooses." Iowa Br. 16. In their view, "[a] State is not required to allow deductions for expenses of doing business, regardless of where those expenses may be incurred." *Id.*

We agree that the federal constitution prescribes no uniform definition of net income for state tax purposes. But it does require geographical neutrality. Even New Jersey acknowledges that it may not, consistent with constitutional limitations, geographically distort the preapportionment tax base by adding phantom income. Br. 25. It should have no greater license to achieve the identical result indirectly by geographically tailoring the allowable deductions. Notions of legislative grace provide no immunity from constitutional scrutiny when the state exercises its taxing discretion in a geographically disparate fashion. That is as true in the case of New Jersey's disallowance of a WPT deduction as it was in the case of New York's geographical tailoring of tax credits in *Westinghouse Electric Corp. v. Tully*, 466 U.S. 388 (1984).

### D. Discrimination Against an Out-of-State Business Activity Is Unlawful Even If There Is No Identical In-State Counterpart

New Jersey's position on discriminatory taxation is straightforward: there can be no discrimination against an out-of-state business activity unless an identical in-state activity is treated more favorably. Br. 13, 39. Under that theory, if a particular form of economic activity is conducted only outside the taxing jurisdiction,



the constitutional protections against tax discrimination have no application, and the state is free to impose whatever special burdens it may choose on any in-state taxpayer that happens to engage in the disfavored out-of-state activity.

We showed in our opening brief (pp. 43-45) why that constricted view of the Commerce Clause would nullify its animating purposes. The brief of amici curiae Committee on State Taxation ("COST") *et al.* treats the issue in greater depth, demonstrating persuasively that "the dangers inherent in the New Jersey taxation scheme are precisely those at which the Commerce Clause was directed: 'economic Balkanization;' disproportionate burdening of out-of-state activities; and obstruction of the 'national free trade area.'" COST Br. 11. New Jersey's brief barely responds to these points.

First, New Jersey argues that Congress, not the state, singled out crude oil producers when it imposed the WPT. Br. 12, 34. But under the Commerce Clause it should not matter whether an industry's geographically localized costs are imposed by federal statute, by state statute, by geological happenstance, or by operation of the economy. The question in each case is whether those costs may be accorded less favorable tax treatment by reason of their association with an activity performed only outside the particular taxing jurisdiction.

Second, the state asserts that the discrimination at issue here "is not drawn along state lines" but reflects a "facially neutral" distinction based "on the nature of the companies' businesses." Br. 12, 13, 37-38. It is true that the New Jersey add-back provision, as construed below, does not expressly single out "non-New Jersey" WPT costs. But facial neutrality is no defense if the effect of a state statute is to allocate tax burdens in a geographically discriminatory fashion. *American Trucking Ass'ns v. Scheiner*, 107 S. Ct. 2829, 2839 (1987). Because no oil is produced in New Jersey, no WPT costs are incurred there. Limiting the add-back provision to "non-New Jer-

sey" WPT costs would therefore be redundant. Even without an express reference to state lines, the provision operates to disfavor a class of exclusively out-of-state costs.

To say that the discrimination is based solely on the nature, not the location, of the taxpayers' businesses is likewise meaningless. Classifying taxpayers generically rather than geographically does not shield an otherwise discriminatory taxing scheme if the generic distinction relates, as it does in this case, to an exclusively extrastate feature of the disfavored class's business.

Third, New Jersey says that the Commerce Clause is not offended because the add-back provision "does not have the tendency to force comparable out-of-state activities to be performed in-state." Br. 39. As the Solicitor General stated, however, the provision could nonetheless "create an incentive to shift resources away from the out-of-State cost-producing activity . . . and into an activity that [does] not incur the special tax burden—perhaps an in-State activity," thereby distorting "[e]fficiency-based business decision-making." U.S. Br. 18-19.

More important, by imposing local tax burdens disproportionately on out-of-state activities, New Jersey is "granting to those conducting activities in the State a reduced-fare (if not a free) ride for the benefits of state government." *Id.* at 18. The measure of that reduced fare in this case is the amount of additional tax revenue that New Jersey raises by adding back WPT costs. Interstate commerce may be made to pay only its fair share, not a disproportionate share, of the local tax burden. *Tyler Pipe Industries, Inc. v. Washington State Department of Revenue*, 107 S. Ct. 2810, 2820 (1987). The add-back provision operates impermissibly to tax one segment of interstate taxpayers more heavily than all other taxpayers solely on account of an out-of-state activity that is integral to their interstate business.

Finally, New Jersey dismisses the threat of retaliatory taxation by pointing to several production states among



the amici curiae supporting its position in this Court. Br. 40-41. But one can as easily draw the opposite inference. The amici argue broadly that states may impose special tax burdens on the exclusively out-of-state economic activities of in-state taxpayers. Iowa Br. 19-27. The fact that other states thirst for the same expansive authority that New Jersey claims for itself reinforces rather than diminishes the risk that retaliatory taxes—and non-retaliatory taxes designed simply to export the local tax burden—will proliferate if states are empowered to enact them.

### E. Geographical Neutrality Is as "Workable" for Income Tax Deductions as for Apportionment Formulas

New Jersey warns that exposing state income tax deductions to the same test of geographical neutrality that applies to apportionment formulas will "create a legal nightmare." Br. 13. But the state's alarmism is out of place here for two reasons.

First, the circumstances in this case present none of the close questions to which New Jersey adverts. As the Solicitor General put it, this is a "stark" case: it involves "a cost that is incurred exclusively out-of-State" and results in "geographic skewing that is pronounced and systemic." U.S. Br. 22. New Jersey's unfavorable treatment of WPT costs necessarily distorts the preapportionment tax base, and exaggerates the New Jersey tax liability, of *every* affected taxpayer. The Court need not resolve here the different issues that might arise if the disfavored costs included both in-state and out-of-state components and if the state's disallowance affected the geographical balance of some taxpayers' tax bases in a manner disadvantageous to the taxing state.

Second, the supposedly intractable problems hypothesized by the state are not nearly as difficult to solve as it imagines. For example, although real property taxes (N.J Br. 13, 44-45) are plainly site-specific costs, they are also ubiquitous. A state may deny a deduction for real prop-

erty taxes without creating an intrinsic asymmetry in its income tax base, as long as it treats out-of-state property taxes no differently from in-state property taxes. Similarly, there is no reason to suppose that interest payments on debt owed to 10 percent or greater shareholders (NJ Br. 18, 45) are any more likely to have a geographical source outside rather than inside any particular state. Disallowing a deduction for such payments is therefore presumptively even-handed and creates no inherent geographical bias in the tax base.

Likewise, while percentage depletion and intangible drilling costs (NJ Br. 13, 42-43) are associated with site-specific mineral production activities, a non-production state may depart from the federal treatment without offending geographical neutrality. It need only treat the capital costs of out-of-state mineral production with no less favor than it treats the capital costs of in-state industries. On the other hand, if a state with no refineries were to single out refining costs for disallowance (NJ Br. 13, 42), every out-of-state refiner's tax base would necessarily be skewed geographically, and the circumstances would therefore be comparable to those presented in this case.

New Jersey has conceded that it may not disfavor crude oil production by adjusting the three-factor apportionment formula in a geographically uneven manner. Br. 25. There is no reason to suppose that a rule of geographical neutrality is likely to be any more unmanageable when applied to income tax deductions than when applied to apportionment formulas.

This Court has always been cautious in defining the constitutional limitations on state taxing power. It has "counseled that the result turns on the unique characteristics of the statute at issue and the particular circumstances in each case." *Boston Stock Exchange v. State Tax Comm'n*, 429 U.S. 318, 329 (1977). But the Court has never done what New Jersey asks it to do here: sanction a new species of extraterritorial taxation, and a



novel form of discrimination against out-of-state business, for fear that forbidding it might lead to future litigation over other state tax mechanisms. New Jersey has not explained why the Court should forgo its historical "case-by-case approach" (*id.*) or suspend the operation of ordinary jurisprudential principles as applied to the "unique characteristics" and "particular circumstances" (*id.*) of this case.

## CONCLUSION

For the reasons stated above and in our opening brief, the judgment of the Supreme Court of New Jersey should be reversed.

Respectfully submitted,

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